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April 21, 2009

AGENDA ITEM 3b

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: AB 125 (De Leon)—As Introduced January 15, 2009

California Employee Savings Program

Sponsor: The New America Foundation

II. PROGRAM: Legislation

III. RECOMMENDATION: Neutral, if Amended

While the Board supports policies that enhance supplemental savings plans as a means to encourage savings for retirement, there are potential risks associated with this bill.

IV. ANALYSIS:

AB 125 would establish the California Employee Savings Program (the "Program") to be administered by the CalPERS Board of Administration. Specifically, this bill would require the Board, if sufficient outside funding is made available and certain conditions are satisfied, to offer one or more individual retirement accounts (IRAs) to California employees of private-sector or non-profit employers that do not already provide their employees access to a retirement savings plan. The IRAs offered under the Program may include traditional IRAs, payroll deduction IRAs, SIMPLE IRAs and SEP IRAs.

Background

Individual Retirement Accounts (IRAs)

Traditional IRAs – include tax-deferred retirement savings accounts whereby taxes are not paid on contributions and investment earnings until withdrawal, and ROTH IRAs, where contributions are made on an after-tax basis and are not subject to taxes upon withdrawal. These IRAs are available whether or not an individual is covered by another retirement plan, however, the income tax deductibility of their contributions may be affected if they or their spouse is covered by an employer retirement plan. The contribution limit is $5000 for 2009. This is the maximum that can be contributed in 2009 regardless of whether the contributions are to one or more traditional IRAs or whether all or parts of the contributions are nondeductible. A traditional IRA is not sponsored by an employer, so the assets are not considered pension plan assets subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), nor are the contributions made through payroll deductions.

Payroll Deduction IRAs – are for employers who do not want to adopt a retirement plan, but still want to allow their employees to save through payroll deductions. The decisions about how much to contribute up to the $5000 limit and when to contribute are made by the employee. Although the limits and the contributions to a payroll deduction IRA are tax-deductible to the same extent as traditional IRAs, it provides a more convenient and consistent means for the employee to make these contributions. Depending upon how the payroll deduction IRA is set up and level of endorsement by the employer, the IRA assets may be subject to ERISA.

Savings Incentive Match Plans for Employees of Small Employers, or SIMPLE IRAs – are a savings option for employers with 100 or fewer employees that allow employees to contribute a percentage of their salary each pay check and to have their employer contribute too. Under a SIMPLE IRA, employees can contribute up to $11,500 annually. Employers can either match up to 3 percent of an employee's wage or make a fixed contribution. SIMPLE IRAs are considered pension plan assets and are subject to ERISA.

Simplified Employee Pensions, or SEP IRAs – allow employers to set up an IRA for their employees. Employers are required to contribute a uniform percentage of pay for each employee, but they are not required to make contributions each year. An employer may contribute up to 25 percent of an employee's compensation up to the annual cap, which is $49,000 in 2009 and subject to annual cost-of-living adjustments for later years. SEP IRAs are considered pension plan assets and are subject to ERISA.

CalPERS' Management of Supplemental Income Plans

CalPERS' Supplemental Income Plans Division currently administers three deferred compensation (DC) plans designed to provide supplemental retirement income to public employees. The first DC plan is a 457 governmental plan ("CalPERS 457 Plan") that is available to employees of all California local public agencies, county superintendents of school offices, and school and community college districts that elect to contract for it. Currently, over 600 participating public agencies contract with CalPERS to offer the CalPERS 457 Plan to allow their employees to voluntarily invest a portion of their salary among their choice of eleven separate Core Investment Funds and fourteen asset allocation funds. Total fees for administration and asset management services of the Investment Funds offered under the CalPERS 457 Plan are less than 1 percent. The

CalPERS 457 Plan also offers a Self-Managed Account option that allows participants to invest in over 4,000 mutual funds at the regular retail rate through a discount brokerage service. CalPERS contracts with ING for program administration, recordkeeping and customer service. State Street Bank provides custodial services.

In addition to the CalPERS 457 Plan, the Supplemental Income Plans Division also administers the Supplemental Contributions Program (SCP), which is an after-tax money purchase pension plan under section 401(a) of the Code that is currently offered to state employees. The third DC plan administered by CalPERS is the State Peace Officers' and Firefighters' (POFF) Plan, which is also a money purchase pension plan under IRC 401(a), that receives specified employer contributions for members of certain collective bargaining units in state service.

Universal Retirement Savings Proposals in Other States

Retirement savings proposals similar to AB 125 have been considered in a number of other states, including Connecticut, Maryland, Michigan, Vermont, and Washington. However, none of these proposals have been signed into law. Maryland and Washington have conducted scoping studies of similar state-administered retirement savings programs as a result of these failed legislative proposals.

<u>Maryland</u> – In 2007, the Legislature considered and rejected Senate Bill 728, which would have established the Maryland Voluntary Employee Accounts Program (MVEAP) administered by the Maryland Teachers and State Employees Supplemental Retirement Plans. Authorized plan structures under the MVEAP would have included 401(a) plans, including 401(k) plans, as well as trusts or savings incentive match plans under 408(p) of the Code. Instead, and at the Legislature's instruction, the Maryland Supplemental Retirement Plans recently conducted a study of Voluntary Employee Accounts to examine cost efficiencies, potential for state liability, and organization and administration requirement with regard to a state-sponsored program.

The study concluded that each participating business would have to routinely and regularly sign and return documents to a central administrator, provide annual reconciliation of contribution history, and follow instructions on distribution and collection of miscellaneous employee communication materials. It estimated that the MVEAP would require a subsidy of between $300,000 and $500,000 a year for at least five to seven years. Estimated costs included: design and drafting of special plan documents that describe the structure of the accounts, specific control mechanisms, and specific employer responsibilities; draft, submit and obtain rulings from the IRS and Department of Labor that approve plan documents with an estimated duration of 12 to 18 months.

Washington – The Legislature has considered five universal retirement savings proposals since 2003. The most recent proposal would have created the Washington Voluntary Accounts Program (WVAP) to offer employees a vehicle for saving and private employers a method for offering benefits. It designated the State Treasurer as the custodian of the WVAP account, and allowed the Washington Department of Retirement Systems (DRS) to implement and operate the WVAP either in-house or through an external third party contract. It also made program implementation and operation contingent on funding and allowed the DRS to freeze or reduce enrollments and establish a waiting list if continued enrollment would cause expenditures to exceed revenues.

This year, the DRS produced a report at the request of the Legislature, which studied the various legal issues and obstacles that must be addressed in order to implement such a plan. The report identified the following three investment options:

- Private Sector Administered Payroll Deduction or Individual IRA offering a single low-cost, low-risk, inflation-protected investment option. This option would allow any financial institution or eligible broker to offer and administer a generic product using the state's name if the product meets the DRS specifications. In the interest of simplification, the employee has no choice of how the money will be invested and the anticipated return would be the same as Treasury Inflation-Protected Securities (TIPS) whether or not the underlying assets are invested in TIPS. The state would market the product and provide referrals to eligible vendors, with marketing costs anticipated to approximate the Washington State Guaranteed Education Tuition Program costs of $650,000 to $750,000 per year. Projected costs for set-up and implementation are $1.9 million with on-going annual costs of $1.4 million. The report suggests these costs can be borne by the state as a social service or economic development program, and/or shared by participating vendors or program participants.

- Private Sector Administered Payroll Deduction or Individual IRA offering a similar single option low-cost, low-risk, inflation-protected investment with a growth component. They hope to achieve all of the same benefits as the simple investment option, but with a mixture of inflation protected investments and a smaller amount of stocks. According to the report, this option is similar to Option 1, except that the underlying investments are more complex and would be designed to combine stability with the opportunity for better returns during good economic times. The disadvantages cited are the additional complexity and expense to administer, both for the financial institution or vendor and for the state because it is multi-year and contains an equity component that would make it more difficult to achieve uniform returns. Projected costs for set-up and implementation of $2.2 million with on-going annual costs of $1.6 million.

- State Administered 401(k) whereby the state would design the basic features of the plan, and could either administer the plan or partner with private sector providers to administer plan, consistent with IRS regulations, with the investments managed by the Washington State Investment Board. The state would create prototype 401(k) plan that private sector employers could adopt. Employees of the sponsoring employers could voluntarily defer a portion of their pay to the plan, and each sponsoring employer could determine whether or not to provide matching contributions. The report notes the major disadvantage of this option is that it would require IRS approval prior to implementation and would be subject to various federal requirements, such as annual testing, reporting, and audits. They project costs for set-up and implementation of $3.4 million with on-going annual costs of $2.1 million.

Options 1 and 2 are based on the concept that savings vehicles exist, but the market needs to be simplified to encourage people to save for retirement with simple, easy-to-access investment vehicles through the workplace. In addition, IRAs are not typically subject to ERISA requirements, so both options would face fewer regulatory hurdles than the 401(k) plan. The report goes on to note that Payroll Deduction IRAs only retain their exemption from ERISA's pension plan requirements if the employer complies with the Federal Department of Labor's interpretation of the exemption provisions, which includes maintaining neutrality so as to not endorse any product or exert any influence over the investments permitted by the IRA sponsor.

DRS recommends beginning the Program by offering first option to encourage workers to begin saving, and reintroducing the concept that some savings should be in very low-risk investments. This option maintains private sector administration of their own retirement savings plans, while providing a low-cost, consumer-oriented option for people who are currently underserved by the market. The report states that the use of payroll deduction has proven an easy and convenient way to encourage employees to become savers, and that features like automatic enrollment could also increase the number of individuals saving for retirement. The DRS claims to have received a positive response to this approach from all stakeholders, and that they believe it is a sound approach to basic saving for retirement, especially if employers offer payroll deduction IRAs.

The report indicates that the Payroll Deduction IRA was designed to expand the use of IRAs by enabling employees to save using direct deposit via their employer's payroll system, however, this IRA is virtually unknown to employers and adoption has been minimal. Adoption of the automatic 401(k) has been more widespread, with the combination of automatic enrollment with advance notice increases employee participation from 75 percent to levels of 85 to 95 percent.

President Obama's Retirement Savings Proposal

In his recent budget plan, President Obama proposed a set of programs that would change the structure of tax-favored retirement accounts and improve incentives to contribute to them. He would mandate automatic 401(k) plans for employers offering retirement plans, which require individuals to opt out of their employer's retirement plan rather than to opt in, but do not change the individual's set of available options.

President Obama also proposes to require employers who do not sponsor other retirement plans to offer access to automatic IRAs, which would allow workers to contribute to tax-favored IRA accounts via payroll deduction. If an employee does not either opt out or specify his or her own IRA account, the employer would automatically contribute a share of earnings to a designated employee account set up on the employee's behalf by a private-sector financial institution. It is the understanding of CalPERS staff that the Administration currently intends that private-sector financial institutions would administer these programs.

Finally, the Obama Administration proposes modifying the current nonrefundable saver's tax credit to make it fully refundable and equal to 50 percent of qualified retirement savings contributions up to $500 for an individual and $1,000 for a couple (for a maximum credit of $250 and $500, respectively). The credit would phase out at a 5 percent rate when adjusted gross income exceeds $32,500 for individuals and $65,000 for couples, with the credit thresholds indexed for inflation in future years.

Proposed Changes

Specifically, this bill would:

Structure

- Require the Board to offer one or more IRAs under the Program, including traditional IRAs, payroll deduction IRAs, SIMPLE IRAs, or other IRAs authorized under Sections 408 and 408A of the Code.

- Allow the Board, in its discretion, to select from among several possible structures and/or features of the IRAs offered under the Program.

- Allow California private-sector or non-profit employers that do not have a retirement plan to participate in the Program, to automatically enroll their employees, and make contributions to their employees' IRA accounts.

- Require employers that do not participate in the Program to allow individual employees to designate a portion of their wages be processed and forwarded by the employer to the Program.

- Authorize the Board to market the Program to employers and employees, and provide retirement education services to participants.

- Authorize the Board to provide cost-effective assistance to participating employers and employees to facilitate compliance of the IRAs offered under the Program with the Code, including tax qualification, or, where applicable, ERISA, or any other legal or accounting requirements.

- Authorize, but does not require, the State Employment Development Department (EDD) to participate in the development and administration of the Program.

Funding

- Provide that provisions of AB 125 become operative only if funds are appropriated in the annual Budget Act or made available through a nonprofit or private entity in amounts sufficient to allow the Board to initiate, study, develop, and obtain the approvals necessary to implement the Program.

- Require all Program expenses and obligations to be funded by its contributions, returns, and assets, except as the Legislature may appropriate funds for this purpose, and prohibits the use of funds in CalPERS' defined plans, health and welfare plans, or its supplemental income plans for public employers/employees.

- Require the Board to seek funding at three specified points in the implementation process – First, to study the viability of the Program; second to design the Program and seek the necessary approvals from the appropriate oversight agencies or departments of the United States government; and finally, to actually implement the Program.

Reporting

- Upon the Board's determination that all the bill's specified conditions necessary to implement the Program have been satisfied, require the Board to report to the Legislature regarding the expectations of the Program, an outline of the Program, and details regarding the administration and projected cost of the Program.

- Upon the Board's determination that all the bill's specified conditions cannot be satisfied, require the Board to report to the Legislature details supporting its conclusion, including the legal, financial, regulatory, and administrative considerations and obstacles, and actions taken to address those concerns. It shall also include suggested changes that the Board believes would make it feasible to implement the Program.

- Upon implementation of the Program, require the Board to file annual reports to the Legislature on the status of the Program, including outreach, investments, and solvency.

- Require the Board to submit a report to the Legislature at least 90 days prior to any suspension or discontinuation of the Program that would address any conditional changes that need to be made by the Legislature in order to continue or improve the Program, and address any of the Board's concerns.

- Require the Board to report to the Legislature on the feasibility of creating a defined benefit (DB) plan option available to employers, only if a budget appropriation is made, or sufficient funds are provided by a nonprofit or private entity, to allow the Board to study, develop, and obtain the approvals necessary to implement the DB option.

Legal Issues

- Require the Board, as a condition of implementing the Program, to seek all necessary approvals, rulings, determinations, etc. from federal entities, including, but not limited to, the IRS, the Department of Labor, and the SEC, to ensure the Program IRAs adhere to all federal requirements regulating the operation of retirement plans and the offering, sale, or distribution of securities under those plans.

- Provide the Board discretionary authority to decide whether or not to implement any IRA arrangement or other retirement plan subject to ERISA;

- Require suspension of Program implementation or ongoing operations if the Board does not:
  1) Obtain satisfactory approval from federal agencies that the IRA plans or arrangements offered under the Program do not jeopardize or alter the current federal tax or legal status of CalPERS operations;
  2) Ensure any payroll deposit IRA offered is not subject to ERISA;
  3) Obtain offers from well-qualified and experienced financial service providers to administer the recordkeeping, investment, and compliance functions;
  4) Determine Program will be self-sustaining.

- Provide that participating employees are not CalPERS members.

- Provide that the exemptions in law provided to public retirement plans shall not apply to the implementation and administration of the Program.

- Provide that authority and responsibility for the Program is with the CalPERS Board of Administration, and not the retirement system.

- Prohibit Program initiation, development, implementation, or administration expenses from being paid by any funds in CalPERS' defined plans, health and welfare plans, or its supplemental income plans for public employers and employees.

- Prohibit state claims resulting from the operation of the Program from being paid by any funds in CalPERS' defined benefit plans, health and welfare plans, or its supplement income plans for public employers/employees.

- Provide that no claims, tax liens, etc. by the state, its agencies or instrumentalities may apply against any IRA accounts or Program assets.

- Provide the Board, CalPERS employees and contracting investment managers with indemnification from the State General Fund for acts related to the implementation and administration of the Program.

- If adequate funding is made available through an appropriation from the Legislature, private-sector, or non-profit entities, AB 125 would require the Board to conduct a feasibility study to determine whether the bill's specified conditions necessary to allow it to offer IRA plans or arrangements to private-sector employees can be satisfied, and report its findings to the Legislature.

- Upon completing a study and reaching the conclusion that the Program is feasible, AB 125 would allow the Board to accept either an appropriation from the Legislature, private-sector, or non-profit funding necessary for it to design the Program, seek federal waivers and approvals, and report its findings to Legislature.

- Upon obtaining adequate an appropriation from the Legislature, private-sector, or non-profit funding necessary for it to implement and administer the Program until it becomes self-sustaining, it allows the Board to hire staff and/or develop RFPs to contract with third-party administrators, investment providers, marketing professionals, to implement and administer the Program.

<u>Legislative History</u>

2008 AB 2940 (De Leon) AB 2940 would establish the California Employee Savings Program ("Program") to be administered by the California Public Employees' Retirement System ("CalPERS"). Specifically, this bill would require CalPERS to offer one or more individual retirement accounts or individual retirement annuities (collectively "IRAs") to California employees of a participating private-sector or non-profit employer. The IRAs offered under the Program may include traditional IRAs, payroll deduction IRAs, SIMPLE IRAs, or other IRAs authorized under Section 408 and 408A of the Internal Revenue Code (the "Code").. *CalPERS' Position: Neutral, If Amended. Held by the Senate Appropriations Committee.*

1997 Chapter 851 (AB 530, Committee on Higher Education) – Established the Golden State Scholarshare Trust Act, administered by the Student Aid Commission, as a structured open savings program for individuals and families to pay future costs of higher education, including public and private colleges, universities and vocational institutions. *CalPERS' Position: None.*

1990 Chapter 1659 (SB 2026, Craven) – Authorized CalPERS to offer a 457 plan, 403(b) plan, or any other form of deferred compensation arrangement authorized by the Internal Revenue Code and approved by the CalPERS Board. The bill requires the program be self-funded through fees assessed against participating employees and/or contracting employers and invested in a series of accounts set-up within the new Public Employees' Deferred Compensation Fund. *CalPERS' Position: Support*

Issues

1. Arguments by Those in Support

   According to the Author, the California Employee Savings Program will offer secure, voluntary and portable individual retirement savings accounts that workers can freely take from job to job without penalty, providing them with the opportunity to build their assets and help prepare them for their retirement, at no cost to taxpayers."

   Organizations in Support: New America Foundation (Co-Sponsor), AARP (Co-Sponsor), AFSCME, California Communities United Institute, Small Business California

2. Arguments by Those in Opposition

   Opponents believe that making people aware of existing private sector options is both more cost-efficient and effective, and that state agencies and legislators can play a helpful role in efforts to expand coverage by increasing public awareness about existing investment options and the tax incentives that minimize start-up costs for employers who offer retirement plans.

   The Securities Industry and Financial Markets Association (SIFMA) indicates that while AB 125 appears to be partially based on the premise that the complexity and cost of administering retirement plans may prevent small businesses from offering retirement plans to their employees, the private sector already offers a number of good, low-cost retirement options, including

SIMPLE IRA and traditional IRA options, with the fees for a SIMPLE IRA plan totaling less than $40 per year, depending on the institution chosen.

SIFMA claims in its review of the Maryland and Washington State studies of the subject that, in both instances, the States would, after a period of time subsidizing the program, end up offering a product to employees that costs the same as or substantially more than that currently being offered by the private sector.

Organizations in Opposition: Securities Industry and Financial Markets Association (SIFMA), National Association of Insurance and Financial Advisors – California (NAIFA-CA), Association of California Life and Health Insurance Companies (ACLHIC).

3. Plan Structure

AB 125 would allow CalPERS to administer the Program through various structures that could limit its direct involvement in the management and fiduciary decisions that employers and qualified retirement plan providers generally make. Most of the bill's requirements can be met through contracts with private-sector service providers, with management and oversight provided by CalPERS' professional staff.

In effect, AB 125 would allow the Board to determine CalPERS' level of involvement in the operations of the Program, from developing and administering the Program completely in-house, to contracting-out all these functions to a third party, or a combination of the two approaches. The legal issues and respective risks will depend upon how the Program is ultimately structured and implemented. The more discretionary control CalPERS has over the Program (i.e. serves as trustee, asset management) the greater the potential legal issues and risks.

4. Plan Design

The intent of AB 125 focuses on increasing retirement savings among the lower-paid and more mobile sectors of the California workforce. However, this effort must be balanced by the need to ensure affected employers are willing to undertake the additional administrative responsibilities and legal liabilities necessary to provide such tax-advantaged retirement savings plans. This difficult balance is achieved through an exhaustive plan design process to research participant behavior, explore administrative structures to increase efficiencies, and compare investment options and strategies.

Because AB 125 requires the Program to be self-sustaining, the IRAs must maintain administrative costs at a level that participants are willing to bear through fees charged either as a percentage of assets in their accounts, or through a fixed annual fee. The highest administrative costs for plan providers are typically those associated with participant enrollment, recordkeeping, termination and distributions, therefore, it may be necessary to restrict eligibility for enrollment until participants have been employed by an employer for a certain period. An alternative approach is to require higher initial contribution amounts to increase likelihood that administrative costs associated with establishing and closing individual accounts can be recovered from participants.

Another consideration is when participants are allowed to make contributions that are too small, the administrative costs of the plan may consume a large percentage of their assets, which tends to discourage participation or encourage cost-shifting. It may be necessary to specify minimum contribution amounts to increase the likelihood that participants are able to enjoy adequate return on their investment after administrative and investment costs are deducted from their accounts. Other common plan design considerations that have an effect on expenses and participation include: terms and conditions of vesting for employer contributions; fixed contributions rates or a range of choices, choice of default investments, terms and conditions of participant access to their retirement savings; and the ability to limit or cease enrollment based on market conditions in order to ensure the solvency of the Program.

For ERISA-covered plans, federal statute and regulations provides “safe harbor” protections for plan sponsors and administrators that have established automatic participant enrollment as part of their plans. The Board should seek similar federal protections for the default investment option it would select under an automatic enrollment feature, as well as selecting the appropriate default contribution percentage or amount, and establishing procedures for participants to opt-out of the Program.

5. Plan Offering Considerations

CalPERS is a governmental plan as defined under Section 3(32) of ERISA and, as such, it is exempt from ERISA coverage. This bill would require CalPERS to offer one or more various types of IRAs, some of which are likely subject to ERISA. Offering traditional IRAs maintained by individuals should not give rise to ERISA coverage. On the other hand, SIMPLE IRAs, SEP IRAs, or other employer-sponsored plans would be subject to ERISA. Payroll deduction IRAs fall somewhere in the middle. CalPERS would need to work with the United States Department of Labor (“DOL”) to make sure that any such payroll deduction IRAs would be exempt from ERISA before offering them under the Program.

Although the Program may be administered through various means, with different features and structures, CalPERS would need to consider whether the IRA assets could be effectively walled off to prevent ERISA creep to the non-ERISA assets managed by CalPERS. If CalPERS lost its governmental plan exemption, CalPERS would be subject to additional responsibilities, duties, and stringent reporting and disclosure requirements under ERISA. CalPERS would also be subject to the jurisdiction of the United States Department of Labor ("DOL") and potential participant lawsuits.

6. <u>Program Start-Up Funding Considerations</u>

   The CalPERS defined benefit plan is a pension plan qualified under Section 401(a) of the Internal Revenue Code (IRC) and, as such, assets of the PERF may only be used for the exclusive benefit of the employees or the beneficiaries of the employers sponsoring the plan. This "exclusive benefit rule" prohibits the use of PERF assets to fund the start-up costs and on-going expenses of the proposed Program. To avoid violating this "exclusive benefit" rule, AB 125 prohibits PERF funds or CalPERS resources from being used for the Program, and instead specifies that other funding sources such as the General Fund and private sector and non-profit entities may be used.

   It will be necessary that the Program receive money from these sources over several years until the Program cannot only become self-sustaining, but also generate sufficient excess revenues to the extent they must be repaid. The Legislature and other authorized entities should consider providing an initial appropriation to cover the required feasibility study, and all or a portion of the Program start-up costs, especially CalPERS' expenses associated with designing and obtaining the approvals and/or exemptions necessary for its implementation, as the Board cannot guarantee repayment of any form of loan to fund these initial tasks, especially if regulatory approvals cannot be obtained, or the Program is not likely to be able to repay the development and implementation costs.

7. <u>Investment Considerations</u>

   Because a portion of current employer and employee contributions are able to cover all existing benefit payments to CalPERS members and their beneficiaries, CalPERS is able to hold investments in the Public Employees Retirement Fund ("PERF") for long periods of time, whether they be equity, real estate or other asset types. Other CalPERS-managed funds and benefit programs such as the Public Employees' Long Term Care Fund do not have similar actuarial experience and liquidity requirements, and consequently, these funds hold fewer asset classes and have different investment strategies. As a result, these other funds experience different rates of investment return from the PERF rate.

   Another major difference between most CalPERS-managed funds and IRAs is that CalPERS funds collectively serve hundreds of thousands of participants and are operated under the assumption they will never be terminated, while an IRA only lasts the lifetime of a single participant. This requires a different investment strategy and asset allocation as participants move through the accumulation phase during their working careers, when asset growth is emphasized, to the distribution phase in retirement, when asset protection becomes more important. CalPERS' experience in managing and selecting investment options for the deferred compensation Supplemental Income Plans it offers to participating public employees may be leveraged for the proposed Program.

After evaluating the costs and benefits of providing various types of investment options and potential participants' interest, the Board would recommend its initial IRA Plan and investment option lineup, which could range from the individual IRA offering a single low-risk, inflation-protected investment option as described in the Washington State report, to a SIMPLE IRA with automatic features and extensive participant choice of outside mutual funds and/or CalPERS-managed funds. Until the study is conducted, CalPERS staff cannot determine whether participant interest and expectations can be reconciled with the requirement that the Program be self-sustaining.

8. <u>Federal Regulatory Considerations</u>

There are some limitations on commingling retirement assets with other types of assets. There rules limit the ability to offer a "group trust" type of investment to individuals and non-governmental plan investors. The actual structure used will need to be carefully reviewed for commingling issues.

Existing federal law requires the trustee or custodian holding IRA assets to be a bank, federally insured credit union, savings and loan association, or entity approved by the IRS to act as a trustee or custodian. Because CalPERS does not meet any of these definitions, it would be necessary to seek additional IRS approval, or contract with a third-party administrator or trustee that satisfies this requirement.

The federal securities laws generally contain exclusions for state entities and their officers and employees from all provisions of the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Exchange Act of 1934. Currently, CalPERS as a governmental entity is exempt from these regulatory structures. When creating the administrative structure of the Program, careful consideration should be given to whether the activity performed by CalPERS under the Program would subject it to these securities laws.

9. <u>Additional Legal Considerations</u>

Federal and state law requires retirement plan assets to be held in trust for the exclusive benefit of retirement plan participants and beneficiaries. Article XVI, Section 17 of the California Constitution grants the CalPERS Board of Administration with plenary authority and fiduciary responsibility for investment of moneys and administration of CalPERS. The Board has a constitutional duty to administer the plan in accordance with its fiduciary responsibility for investment of the moneys and administration of the pension system. The Board must discharge its duties with respect to the pension system solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable administrative expenses. The California Constitution specifies that the Board's duty to participants and their beneficiaries shall take precedence over any other duty.

Under AB 125, the Board would also be charged with administering the Program for employees of participating private-sector employers. If the Board has a legal duty to administer the Program established under AB 125 and all of CalPERS benefit programs, including its pension, health, and long-term care plans, this may present potential conflicts of interests between the interests of the CalPERS public pension plans and the plans administered under the Program.

Article XVI, Section 17 of the California Constitution generally prohibits the State from loaning its credit for subscribing to, or otherwise having an interest in the stock of any company, association, or corporation. This prohibition, however, does not apply to a retirement board of a "pubic pension or retirement system." As used in subdivision (h) of this Section, the term "retirement board" means the board of a "public employees' pension or retirement system."

It is not clear whether this exemption would extend to the Board's administration of the Program since it would expand coverage to private-sector employees, as opposed to public employees. This may become an issue depending on how the Program is structured. For example, if CalPERS were to offer its internally managed funds as "side-by-side" funds to the participants of the Program, CalPERS would have an interest in stock. Because the exemption to the constitutional prohibition only extends to a retirement board of a public employees' pension or retirement system, this exemption would not likely extend to participants under the Program. Accordingly, a constitutional amendment might be necessary if the Program included CalPERS internally managed funds.

10. Federal Automatic IRA Legislative Proposals

In the last Congressional session, H.R. 2167 and S.1141 were introduced to allow employees not covered by qualified retirement plans to save for retirement through automatic payroll deposit IRAs, and provide the self-employed with similar arrangements. Employers would be required to allow employees to make a payroll-deduction deposit into IRAs. Although these proposals did not progress during the last Congress, the Obama administration has expressed support for these ideas and has included them in his FY 2010-11 federal budget, which could be an appropriate vehicle to address the regulatory issues raised in this analysis. It may be prudent to wait for the passage of the next federal budget or implementing legislation before a state-sponsored program is created.

11. Alternative Approaches to Meet the Proposal's Intent

Placing the administration of this Program with another state agency would eliminate a number of the legal issues and risks associated with administering a private-sector retirement savings plan through a public retirement system. State agencies with related expertise include the Department of Personnel Administration (which administers the State SavingsPlus Program that includes the 401(k) plan and the 457 deferred compensation plan for state employees), the Controller, the Treasurer (which administers the ScholarShare Program), or numerous existing state finance boards. This approach is illustrated in the recent legislative proposal in Connecticut which would have required the State Controller solicit, select and oversee a third-party administrator to provide a model 401(k) plan to small employers.

12. Legislative Policy Standards

CalPERS' Legislative Policy Standards suggest a neutral position or no position for proposals that have conflicting policy implications. Among these significant considerations, the Board must balance its support of policies that enhance supplemental savings plans as a means to encourage participants to save for retirement and supplement their defined benefit pensions, with its opposition to policies that potentially threaten the Trust. Therefore, staff recommends that the Board adopt a NEUTRAL, if amended, position on AB 125.

This bill should be amended to:

- Prohibit the Board from entering into any agreement that provides funding to the Program that requires repayment, unless the agreement specificies that repayment may only begin after Program fees have generated sufficient revenue to pay the Program's accrued administrative costs;
- Require the Board obtain safe-harbor assurances from the IRS for any default investments established under any automatic IRA option;
- Clarify that an entity other than the Board shall be responsible for ensuring that employers that do not offer their own retirement alternatives must process employee requests to participate in the Program;
- Allow the Board to delay the start of the study, development and approval process until after the successful completion of the CalPERS Pension System Resumption project; and
- Other minor clarifying amendments.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Cost

Although the intent of AB 125 is for the Program to be self-funded and have the costs fully covered by fees deducted from the participants' IRA contributions, it would be necessary for the State to provide sufficient funds to CalPERS to cover its study, start-up and ongoing costs. In addition, the bill allows the Board to accept funding from non-profit and private sector entities to fund the various Program phases. While it is anticipated by the bill's sponsor that administrative costs would be recovered through participant fees, this would depend upon on the level of participation and the amount of assets in the Program. Therefore, the costs of CalPERS for the start-up and operational phases will require an outside funding until the Program is self-sustaining. Continuing funding may be required for an indefinite period pending the build-up of assets sufficient to generate fee revenues off-setting the Program's annual operational costs.

In addition, AB 125 would provide indemnity to the Board from the State General Fund for any claim or loss sustained by reason of any decision or action related to the administration of the Program. The potential liability from this Program is real, so this creates a potential litigation expense for the State.

Administrative Costs

CalPERS' costs for developing, administering, and marketing the Program can be divided into three phases: (1) the study/development/approval phase, whereupon the Board determines whether the necessary conditions for implementation can be met and the Legislature determines whether it will commit to funding the Program until it becomes self-sustaining; (2) the start-up/implementation phase; and (3) the operating/ongoing administration phase. A rough estimate of CalPERS' study costs are outlined below.
CalPERS' estimated study costs would be approximately $1.69 million over a period of approximately 24 months. However, this estimate does not include any EDD study costs, and CalPERS' actual study costs may be greater. If the General Fund appropriation or grant from another entity is insufficient to complete the study, CalPERS will suspend study efforts until sufficient funding is available. It will be necessary to gauge potential participant interest, identify suitable investment alternatives, and develop a reasonable estimate of potential Program start-up costs, and ongoing costs and revenues in order to determine how long the Program will take to meet the sponsor's intent that its costs would be recovered through the fees charged participants. CalPERS staff recommends AB 125 be amended to provide a General Fund appropriation to cover these

costs and allow the Board to provide a complete report to the Legislature in an expedited manner.

This amount includes approximately $75,000 to conduct a market survey to determine: likely participation rates, participants' comfort with various investment vehicles and risk appetite, contribution levels, and the rate of account closures and rollovers. This amount also includes approximately $500,000 to secure the services of outside tax and securities counsel to, among other things, assist CalPERS in obtaining the necessary federal regulatory approvals to provide traditional IRAs and payroll deduction IRAs. If CalPERS were to seek approvals for the authorized ERISA-regulated SIMPLE and SEP IRAs, there would be at least $250,000 to $500,000 in additional legal costs.

This estimate also includes approximately $1.12 million for 10.4 PYs to carry out the professional and administrative tasks associated with developing and evaluating various Program elements for consideration by the Board and the Legislature. These tasks include, but are not limited to: Program design, identifying customer service, participant education, systems automation, accounting, auditing and financial reporting costs, developing and administering the request for proposal (RFP) process for market survey and legal services, as well as the request for information (RFI) process to determine interest and likely costs for third-party administrator, trustee, investment and marketing service providers. CalPERS anticipates the costs and expenses charged by this last group of service providers would be finally determined based on the scope of work and the bids submitted through an RFP process during the implementation phase. These fees would be assessed on participant accounts, in addition to fees associated with the costs incurred by the Program itself.

These estimates do not include marketing costs or the costs of collecting and processing employer and participant records and contributions, which are expected to be substantial. For example, the EDD estimated for last year's AB 2940 that it would experience approximately $36 million in one-time costs to implement the recordkeeping and collection functions of the proposed Program, and approximately $18 million per year in ongoing administrative costs. It is difficult to determine how much it might cost to administer and market the Program, or perform the employer reporting function in-house or contract with a third-party administrator until the Board completes the Program study and development process.

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